VZCZCXRO7648
RR RUEHCN RUEHVC
DE RUEHGH #0654/01 2780929
ZNR UUUUU ZZH
R 050929Z OCT 07
FM AMCONSUL SHANGHAI
TO RUEHC/SECSTATE WASHDC 6333
INFO RUEHOO/CHINA POSTS COLLECTIVE
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RHEHNSC/WHITE HOUSE NATIONAL SECURITY COUNCIL WASHINGTON DC
RUEHGH/AMCONSUL SHANGHAI 6815

UNCLAS SECTION 01 OF 04 SHANGHAI 000654

SIPDIS

SENSITIVE
SIPDIS

STATE PASS FEDERAL RESERVE BOARD FOR JOHNSON/SCHINDLER; SAN
FRANCISCO FRB FOR CURRAN/LUNG; NEW YORK FRB FOR DAGES/CLARK
STATE PASS CEA FOR BLOCK
STATE PASS USTR FOR STRATFORD/WINTER/MCCARTIN/LOI/READE
USDOC FOR 4420
USDOC FOR ITA/MAC DAS KASOFF, MELCHER AND MCQUEEN
TREASURY FOR EXEC - TSMITH, OASIA/ISA -DOHNER/BAKER/CUSHMAN
TREASURY FOR WRIGHT AND AMB HOLMER
TREASURY FOR SOBEL AND MOGHTADER
NSC FOR MCCORMICK AND TONG

E.O. 12958: N/A
TAGS: EFIN EINV PGOV CH
SUBJECT: SHANGHAI BANKERS ON RMB, PROTECTIONISM AND THE FUTURE

REF: SHANGHAI 504

SHANGHAI 00000654 001.2 OF 004

(U) This cable is sensitive but unclassified and for official use only. Not for distribution outside of USG channels or via the internet.

¶1. (SBU) Summary: China's weak and rigid exchange rate is increasing costs and inhibiting innovation in China's financial sector. Shanghai officials and banking leaders told a visiting Treasury delegation that growing protectionism in the financial services sector would make increased foreign penetration difficult. Foreign banks that had incorporated locally are facing increased regulatory interference and mixed results in opening new branches, while a bank that opted not to incorporate locally faces increased costs. Foreign banks are also facing an increased cost in doing business due to recent reductions in their foreign debt quotas. The ongoing need for China's central bank to sterilize its foreign exchange purchases is placing an increased burden on Chinese banks as they are forced to hold more and more central bank assets. End summary.

¶2. (SBU) Visiting Treasury DAS Mark Sobel and Embassy Finance Minister Counselor David Loevinger along with Shanghai ConGen Pol/Econ Chief met with financial service sector officials and banking leaders during a September 17-18 visit to Shanghai. They met with Wachovia Bank Shanghai Branch Managing Director/General Manager Ben Kinnas, JP Morgan Chase Bank Vice Chairman Andrew Zhang, Bank of Tokyo-Mitsubishi UFJ, (China) Ltd (MUFG) Senior Manager Ryan Hart, and Standard Chartered Senior Economist Stephen Green on September 17. On September 18 they met with Citibank CEO Richard Stanley and Shanghai Metropolitan Financial Services Office (SMFSO) Deputy Director General Fang Xinghai. Meetings with Chinese mutual fund companies' representatives will be reported septel.

Foreign Investment in the Securities Sector

¶3. (SBU) SMSFO's Fang said that protectionism in China's

financial sectors is growing. A major source of this protectionism is the feeling among some sectors of the Chinese populace that banks, as state assets, have been sold too cheaply. This feeling has been reinforced by the massive profits generated by the recent IPOs of several state-owned commercial banks. Wachovia's Kinnas separately agreed saying that the Chinese Banking Regulatory Commission (CBRC) has recently expressed concern at the purchase of stakes in city commercial banks by foreigners.

¶4. (SBU) Fang said the increasing Chinese protectionism in the securities sector comes from two sources -- domestic firms fear increased competition and some public policy researchers believe that opening to foreign competition threatens national economic security. To assuage concerns of the second group, the United States needs to show better how other countries have opened their securities sector without losing domestic players, such as in Taiwan, South Korea, Malaysia and Indonesia.

¶5. (SBU) Fang suggested that one remedy for this protectionism could be new, post-WTO, framework agreement on financial services. Making this agreement politically acceptable for the Chinese would necessitate a quid pro quo where both sides would make concessions. Fang suggested that the United States could relax restrictions on high-tech exports in exchange for greater RMB appreciation.

¶6. (SBU) Fang hoped that policies on equity caps in the banking and securities sectors would change after the upcoming Communist Party Congress that convenes in Beijing on October 15). These caps, according to Fang, differ according to industry due to the different personalities of the regulators. Upcoming personnel changes could affect policy. USG pressure can be of help in opening the sector, as long as it is "firm and consistent," he said.

¶7. (SBU) Several firms voiced frustration with their ability to enter the securities market. JP Morgan's Zhang said the CBRC had turned down its petition to underwrite government bonds.

Now that JP Morgan is locally incorporated, Zhang hopes that the CBRC will reconsider its decision. However, he said, regulations on underwriting corporate bonds unclear. While foreign banks cannot trade commercial paper or long-term listed corporate bonds, they can trade government bonds and bank debt. Wachovia's Kinnas also noted his bank's interest in being able to trade financial derivatives.

¶8. (SBU) Citibank's Stanley said that foreign firms want securities licenses that allow for the provision of a full range of investment banking and brokerage services. He noted rumors that China might lift equity caps on investment in securities firms, but expected this would only apply to joint ventures (JVs) with licenses limited to underwriting stocks. He expressed concern that, using China Construction Bank, Bank of China and ICBC as models, the Chinese Securities Regulatory Commission (CSRC) may meet its Strategic Economic Dialogue commitment to allow foreign JVs to expand the scope of their business only by allowing them to take minority stakes in the largest Chinese brokerages. This would limit the ability of foreign firms to gain management control of their JVs in China.

¶9. (SBU) Stanley also pointed to regulatory fragmentation as a frequent obstacle to financial market development. Though Citibank has received approval from the CBRC to issue debit and credit cards, the People's Bank of China (PBOC) is pressing Citi to move its payment processing system onshore, ostensibly due to privacy concerns about having data on Chinese households stored abroad.

Local Bank Incorporation: A Mixed Bag

¶10. (SBU) Both Citibank and MUFG have recently completed the

process of incorporating as local Chinese banks. Stanley repeated his concerns that the regulators are being far more intrusive than expected. (Reftel) CBRC is imposing a local Chinese corporate structure on locally incorporated banks, including a geographic management approach that conflicts with Citibank's product line approach. The Chinese approach increases the power of branch managers. Though Citibank's application for a branch in Dalian was recently approved, approvals of other new branches are "a slog," and continue to be tied to the issue of Chinese banks' access to the United States market. In an attempt to gain regulators' favor, Citibank will open a modified village bank (only lending) even though it expects it will lose money. (Note: Rural finance reform was a primary focus of the National Financial Work Conference in January 2007. Chinese banks, such as the Bank of Communications (BOCOM), have also been asked to consider opening branches in rural areas or to partner with one of the many failing rural cooperative banks. A BOCOM official told Econoff in September that any such venture would lose money and that Chinese banks would be hesitant to pursue it. End note.)

¶11. (SBU) In contrast to Citibank, MUFG's Hart said that MUFG experience with local incorporation had largely been positive. It had benefited from an accelerated approval process for new bank branches. MUFG, however, does not conduct retail RMB banking.

¶12. (SBU) Wachovia, on the other hand, opted not to incorporate locally and, as a result, was required by the CBRC to increase its capital holdings. Wachovia's Kinnas said that the capital requirement for non-locally incorporated banks "is far too high" and acts as a major impediment to United States regional banks who want to do non-retail banking business in China.

-- ----------
Shrinking Foreign Debt Quota Slows Growth, Raises Costs
-- ----------

¶13. (SBU) The State Administration of Foreign Exchange (SAFE) March 2007 decision to reduce banks' foreign debt quotas in order to clamp down on short-term foreign currency denominated borrowing has raised banking costs and constrained growth of their banks, said several interlocutors. This policy took

effect at a time of rising demand for foreign currency denominated debt and a shrinking supply of onshore foreign currency deposits as Chinese households and firms adjust the currency composition of their assets and liabilities to benefit from expected RMB appreciation. The result, according to JP Morgan's Zhang, has been to create a "dollar liquidity crunch," one that the PBOC has done nothing to solve. MUFG's Hart said that banks are paying a premium -- over 100 basis points over LIBOR -- to borrow U.S. dollars on shore.

¶14. (SBU) Stanley said Citibank's foreign debt quota will be fully obligated by March 2008. He had also heard that SAFE was considering a further reduction of foreign debt quotas. Stanley said this would not necessarily be a disaster for the larger foreign banks that are well-established in China, like Citibank, since they have a proportionally larger RMB deposit base, but smaller banks would be hurt.

¶15. (SBU) Wachovia's Kinnas noted that while SAFE's intent is to limit speculation on the RMB and reduce capital inflows, the reduction of foreign borrowing is adversely impacting financial services, such as the financing of imports or re-lending to offshore customers that have no net balance of payments impact.

¶16. (SBU) Zhang said that in terms of banks' financing RMB denominated lending, RMB deposits are the cheapest means, followed by the swapping of offshore dollar borrowing for RMB, with inter-bank RMB borrowing being the most expensive. Thus, restricting foreign borrowing raises the costs of RMB financing and benefits Chinese banks who are the main suppliers of RMB to the inter-bank market. Moreover, limits on foreign currency

borrowing, along with foreign banks' limited deposit base, restriction on inter-bank borrowing (not more than twice their capital) and inability to issue RMB bonds all serve to further constrain the ability of foreign banks to grow.

Exchange Rate Policy

¶17. (SBU) Standard Chartered's Stephen Green said that he is seeing a growing acceptance among Chinese decision makers, even among the more conservative officials of the National Development and Reform Commission (NDRC), that faster pace of RMB appreciation is needed. However, the economy is not slowing, and Green said he saw no consensus among high-level leaders that there is a need to slow the economy, or that they considered the current upsurge in inflation to be a major problem. Continued large-scale sterilized intervention is adversely impacting banks' income, with Citibank's Stanley noting that PBOC assets (including sterilization bonds and reserves) now account for 25 percent of Citibank's financial assets in China.

¶18. (SBU) According to JP Morgan's Zhang, the lack of foreign currency hedging instruments contributes to the Chinese authorities' reluctance to allow a faster rate of RMB appreciation. However, he noted, banks' inability to short foreign currencies, except to offset the long position of a customer with an approved underlying current account transaction, limited the development of a liquid foreign currency derivatives market.

The Future of Chinese Financial Services

¶19. (SBU) SMFSO's Fang said that a working group that includes the Shanghai mayor, Shanghai's Financial Services Office, and local regulators had recently formulated a three-part strategy to turn Shanghai into a global financial center. The plan is to: (1) Grow Shanghai's financial markets, making Shanghai the place where prices of Chinese financial assets are determined; (2) Attract more financial firms, especially large state-owned enterprises currently located in Beijing; and (3) Create a financial sector arbitration body. In Fang's vision, there would be a division of labor between Hong Kong and Shanghai, with Hong Kong being China's center of foreign-exchange-based

financial services, and Shanghai acting as a hub for RMB services.

Comment: The High Price of a Rigid RMB

¶20. (SBU) Conversations with financial sector firms in Shanghai highlight how China's rigid exchange rate is increasing costs and inhibiting innovation in China's financial sector. China's large and rising balance of payments surplus and its rigid exchange rate require the monetary authorities to maintain large scale foreign currency intervention. This keeps the growth of monetary aggregates high and its cost of capital low, resulting in continued high rates of investment, particularly in the tradable sector. This high rate of fixed asset investment contributes to higher export growth, perpetuating the liquidity induced investment cycle. To contain investment growth and the rise in asset prices, monetary authorities are raising interest rates. But to keep higher Chinese interest rates (and lower U.S. interest rates) from inducing even more capital inflows, SAFE is tightening restrictions on capital inflows and continues to prohibit banks from taking short foreign currency positions, constraining liquidity in the foreign exchange market.

¶21. (U) Embassy Finatt cleared this cable.
JARRETT